



[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-125135-15]

RIN 1545-BM90

Ownership Attribution for Purposes of Determining Whether a Person Is Related to a Controlled Foreign Corporation; Rents Derived in the Active Conduct of a Trade or Business

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide rules regarding the attribution of ownership of stock or other interests for purposes of determining whether a person is a related person with respect to a controlled foreign corporation (CFC) under section 954(d)(3). In addition, the proposed regulations provide rules for determining whether a CFC is considered to derive rents in the active conduct of a trade or business for purposes of computing foreign personal holding company income (FPHCI). The regulations would affect United States persons with direct or indirect ownership interests in certain foreign corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-125135-15), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC

20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-125135-15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-125135-15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Rose E. Jenkins at (202) 317-6934; concerning submissions of comments and requests for a public hearing, Regina L. Johnson at 202-317-6901 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

#### **Background**

This document contains proposed amendments to 26 CFR part 1 under sections 954 and 958 of the Internal Revenue Code (Code). Section 954(a) defines foreign base company income (FBCI), which is a category of subpart F income. Subpart F income generally is income earned by a CFC that is taken into account in computing the amount that a United States shareholder (as defined in section 951(b)) of the CFC must include in income under section 951(a)(1)(A). FBCI includes foreign personal holding company income, as defined in section 954(c), as well as certain types of income from sales and services. The determination of whether certain types of sales and services income constitute FBCI depends, in part, on whether the income is earned from a transaction that involves a related person, as defined under section 954(d)(3). See section 954(d) and (e). The definition of related person under section 954(d)(3) is also relevant in determining whether certain income qualifies for an exception to FPHCI. See, for example, sections 954(c)(2)(A), 954(c)(3), and 954(c)(6). As provided in

section 952(a)(2), subpart F income also includes insurance income (as defined under section 953), and the rules in section 953 similarly reference the definition of related person in section 954(d)(3). The definition of related person under section 954(d)(3) is also relevant in determining whether an exception to the definition of United States property applies for purposes of section 956. See section 956(c)(2)(L)(ii)(II).

Additionally, certain provisions outside of subpart F<sup>1</sup> reference the definition of related person in section 954(d)(3). See, for example, sections 267A, 904(d)(2)(I), 988(a)(3)(C), 1297(b)(2), and 1471(e)(2).

Section 954(d)(3) provides that a person is a related person with respect to a CFC if the person is (i) an individual who controls the CFC; (ii) a corporation, a partnership, a trust, or an estate that controls or is controlled by the CFC; or (iii) a corporation, a partnership, a trust, or an estate that is controlled by the same person or persons that control the CFC. With respect to a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of (i) the total voting power of all classes of stock entitled to vote or (ii) the total value of stock of the corporation. With respect to a partnership, trust, or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests in the partnership, trust, or estate. Section 954(d)(3) states that “rules similar to the rules of section 958 shall apply” for purposes of determining ownership. Section 958 provides rules for determining direct, indirect, and constructive stock ownership and states that such rules “shall apply” for purposes of section 954(d)(3) to the extent that the effect is to treat a person as a related person within the meaning of section

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<sup>1</sup> References in this preamble to subpart F are references to subpart F, part III, subchapter N, chapter 1 of the Code.

954(d)(3). See section 958(b). Sections 954(d)(3) and 958 were added to the Code in 1962, as part of the legislation that enacted the subpart F regime, and section 954(d)(3) provided as originally enacted that “the rules for determining ownership of stock prescribed by section 958 shall apply.” Revenue Act of 1962 (Public Law 87-834, 76 Stat. 960). The change in the language of section 954(d)(3) to provide for the application of rules “similar to the rules of” section 958 was made in 1986, but no corresponding change was made to the language in section 958. Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2085).

Final regulations published in the **Federal Register** on May 15, 1964 (T.D. 6734, 29 FR 6385), cross-referenced section 958 and the regulations thereunder for purposes of determining ownership under section 954(d)(3) as then in effect. Final regulations published in the **Federal Register** on September 7, 1995 (T.D. 8618, 60 FR 46500), and corrected on December 4, 1995 (60 FR 62024), revised the regulations, in part to provide that the principles of section 958, modified to apply to domestic as well as foreign entities, applied for purposes of determining direct and indirect ownership under section 954(d)(3). Thus, under current §1.954-1(f)(2)(iv), the principles of section 958(a) and (b) apply, without regard to whether an entity is foreign or domestic, to determine direct and indirect ownership for section 954(d)(3) purposes. The existing regulations do not provide any additional guidance beyond this general statement. These proposed regulations would revise the existing regulations under section 954(d)(3) to provide some specific guidance on the application of principles similar to the constructive ownership rules in section 958(b).

This document also proposes to revise rules under section 954(c). FPHCI, as defined in section 954(c), generally includes rents. Section 954(c)(1)(A). However, rents are excluded from FPHCI if they are received from a person other than a related person and derived in the active conduct of a trade or business within the meaning of section 954(c)(2)(A) and §1.954-2(c) (the active rents exception). These regulations propose to revise the rules under section 954(c) to provide guidance on the treatment of amounts (including royalties) paid or incurred by a CFC in connection with the CFC's rental income for purposes of the active rents exception.

### **Explanation of Provisions**

#### **1. Definition of Related Person in Section 954(d)(3)**

Section 1.954-1(f)(1), like section 954(d)(3), provides that a person is a related person with respect to a CFC if the person is (i) an individual who controls the CFC; (ii) a corporation, a partnership, a trust, or an estate that controls or is controlled by the CFC; or (iii) a corporation, a partnership, a trust, or an estate that is controlled by the same person or persons that control the CFC. Section 1.954-1(f)(2) provides that, with respect to a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or the total value of stock of the corporation. With respect to a trust or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests of the trust or estate. With respect to a partnership, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the capital or profits interest in the partnership.

Section 954(d)(3) provides that rules similar to the rules of section 958 apply for purposes of determining whether a person is a related person. Similarly, current §1.954-1(f)(2)(iv) states that the principles of section 958 apply to determine direct or indirect ownership for purposes of §1.954-1(f) and further provides that the principles of section 958 apply without regard to whether a corporation, partnership, trust, or estate is foreign or domestic or whether an individual is a citizen or resident of the United States.

Under section 958(a)(1), stock is considered owned by a person if it is owned directly or indirectly through certain foreign entities under section 958(a)(2). In relevant part, section 958(b) provides that section 318(a) (relating to the constructive ownership of stock) applies for purposes of section 954(d)(3), subject to certain modifications, to the extent that the effect is to treat a person as a related person within the meaning of section 954(d)(3). Section §1.958-2 sets forth the rules in section 318(a) as modified by section 958(b).

Section 318 provides rules that attribute the ownership of stock to certain family members, between certain entities and their owners, and to holders of options to acquire stock. Section 318(a)(1) provides rules attributing stock ownership among members of a family, and section 318(a)(2) provides rules attributing stock ownership “upward” from an entity to the owner of an entity. In addition, section 318(a)(3) provides specific rules that attribute the ownership of stock “downward” from the owner of an entity to the entity. In particular, section 318(a)(3)(A) provides that stock owned, directly or indirectly, by or for a partner in a partnership or a beneficiary of an estate is considered owned by the partnership or estate. This provision applies to all partners and beneficiaries without regard to the size of their interest in the partnership or estate.

See also §1.958-2(d)(1)(i). Section 318(a)(3)(B) similarly provides, subject to certain exceptions, that stock owned, directly or indirectly, by or for a beneficiary of a trust (or a person who is considered an owner of a trust) is considered owned by the trust. See also §1.958-2(d)(1)(ii). In comparison, section 318(a)(3)(C) attributes stock owned, directly or indirectly, by or for a person to a corporation only if 50 percent or more in value of the stock in the corporation is owned, directly or indirectly, by the person. See also §1.958-2(d)(1)(iii). Section 318(a)(4) provides that a person that has an option to acquire stock is considered to own the stock. See also §1.958-2(e).

The Department of the Treasury (Treasury Department) and the IRS are concerned that, in certain situations, the application of the section 318(a)(3)(A) and (B) constructive ownership rules, if incorporated into §1.954-1(f) by the reference to section 958, could produce inappropriate results when defining related person for purposes of section 954(d)(3). For example, if two otherwise unrelated domestic corporations each owned interests in a partnership, the partnership would be treated under section 318(a)(3)(A) as owning any stock owned directly or indirectly by the unrelated domestic corporations. Thus, for purposes of section 954(d)(3), the partnership would be treated as controlling any corporations, including CFCs, in which one of the domestic corporations owned more than 50 percent of the stock, regardless of the size of the domestic corporation's ownership interest in the partnership, such that a CFC of one of the domestic corporations would be treated as related to a CFC of the other domestic corporation.

Treatment of the domestic corporations' CFCs as related persons with respect to one another under section 954(d)(3) could be relied upon by taxpayers, for example, to

treat payments of interest between the otherwise unrelated CFCs as interest that is eligible for the exception from FPHCI in section 954(c)(6). Similarly, a sale of personal property between a CFC of one domestic corporation and a CFC of the other domestic corporation could give rise to foreign base company sales income under section 954(d). The Treasury Department and the IRS do not believe that either of these results is appropriate when the domestic corporations each own 50 percent or less of the partnership because the domestic corporations (and thus their CFCs) do not have a significant relationship to each other, for purposes of section 954(d)(3), which itself refers to ownership of “more than 50 percent” of stock or other ownership interests, and subpart F more generally.

Similarly, when two unrelated domestic corporations each own exactly 50 percent of the stock of a joint venture corporation, that joint venture corporation would be treated under section 318(a)(3)(C) as owning other stock owned by the domestic corporations (including stock of CFCs) and, accordingly, could be treated as controlling the domestic corporations’ CFCs, such that a CFC of one of the domestic corporations would be treated as related to a CFC of the other domestic corporation. The Treasury Department and the IRS do not believe that section 954(d)(3) was intended to treat the CFCs of the domestic corporations as related persons with respect to each other or with respect to the joint venture corporation in these circumstances, given that no person owns more than 50 percent of both the joint venture corporation and one of the CFCs directly or indirectly, as directly or indirectly would commonly be understood. Accordingly, the Treasury Department and the IRS interpret section 954(d)(3) to qualify the application of the constructive ownership rules in section 318(a)(3).

Concerns about the application of the downward attribution rules of section 318(a)(3) similar to those discussed in this Part 1 were raised in connection with proposed regulations under section 385 (REG-108060-15) (the section 385 proposed regulations) published by the Treasury Department and the IRS in the **Federal Register** on April 8, 2016 (81 FR 20912), as discussed in the preamble to the final regulations under section 385 (TD 9790) (the section 385 final regulations) published by the Treasury Department and the IRS in the **Federal Register** on October 21, 2016 (81 FR 72858). See Part III.B.2.c.v of the Summary of Comments and Explanation of Revisions (81 FR 72866-72867). Accordingly, the section 385 final regulations revised the rules in the section 385 proposed regulations concerning the definition of an expanded group to provide that section 318(a)(3) generally does not apply for such purpose. See §1.385-1(c)(4)(iii)(A).

As noted in the Background section of this preamble, until 1986, section 954(d)(3) and section 958(b) both provided for the rules in section 958(b) to apply for purposes of section 954(d)(3). Although section 958(b) was not changed in 1986, when section 954(d)(3) was amended to provide that rules “similar to” those in section 958 would apply, the change to section 954(d)(3) indicates that Congress intended for the Treasury Department and the IRS to prescribe rules regarding the incorporation of section 958(b) into the definition of a related person under section 954(d)(3) with such modifications as may be appropriate. For the foregoing reasons, and consistent with the section 385 final regulations, the Treasury Department and the IRS propose, pursuant to the grant of regulatory authority to the Secretary under section 7805(a), to revise §1.954-1(f) to provide that the rules of section 318(a)(3) and §1.958-2(d) do not

apply for purposes of section 954(d)(3) and §1.954-1(f). Section 1.958-2 is also proposed to be revised to cross-reference the limitations on its applicability in §1.954-1(f). However, the revision to §1.954-1(f) does not preclude a corporation, partnership, trust, or estate from being treated as controlled by the same person or persons that control the CFC under the other rules that remain applicable for purposes of section 954(d)(3) and §1.954-1(f). For example, if one domestic corporation (USP1) held 51 percent of the stock of a joint venture corporation, while an unrelated domestic corporation (USP2) held 49 percent of its stock, the joint venture corporation would continue to be a related person with respect to a CFC in which USP1 owned 51 percent of the stock (CFC1) as a result of USP1's direct ownership of more than 50 percent of both entities, notwithstanding the fact that the joint venture corporation would no longer be treated as owning the stock of CFC1 owned by USP1.

The Treasury Department and the IRS also are concerned that the application of the option attribution rule in section 318(a)(4) in the context of section 954(d)(3) could lead to inappropriate results. If, for example, two otherwise unrelated domestic corporations owned 51 percent and 49 percent, respectively, of the total value of the stock of a joint venture CFC, and the 49-percent owner also held an option to acquire an additional 2 percent of the corporation, the 49-percent owner could take the position that it, as well as the 51-percent owner, controlled the CFC for purposes of section 954(d)(3). Based on this position, payments of interest between the joint venture CFC and another CFC of the 49-percent owner would be eligible for the exception from FPHCI in section 954(c)(6). The Treasury Department and the IRS have determined that it would be inappropriate to allow taxpayers to effectively elect related person status

using options in this manner. Accordingly, these proposed regulations provide that section 318(a)(4) does not apply to treat a person that has an option to acquire stock or an equity interest, or an interest similar to such an option, as owning the stock or equity interest for purposes of the section 954(d) related person definition if a principal purpose for the use of the option or similar interest is to cause a person to be treated as a related person with respect to a CFC (the option anti-abuse rule).

Section 7(d) of Notice 2007-9, 2007-1 C.B. 401, stated that regulations containing a similar rule would be issued, providing that if a principal purpose for the use of the option or similar interest is to qualify dividends, interest, rents, or royalties paid by a foreign corporation for the section 954(c)(6) exception, the dividends, interest, rents, or royalties received or accrued from such foreign corporation will not be treated as being received or accrued from a CFC payor and, therefore, will not be eligible for the section 954(c)(6) exception. Notice 2007-9 indicated that section 7(d) would be effective for taxable years of foreign corporations beginning after December 31, 2006. Accordingly, these proposed regulations also contain, pursuant to the grant of regulatory authority to the Secretary under section 954(c)(6), the rule described in Notice 2007-9 (the Notice 2007-9 option anti-abuse rule), which is proposed to apply for taxable years of CFCs beginning after December 31, 2006, and ending before the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and for the taxable years of United States shareholders in which or with which such years end. Section 7(d) of Notice 2007-9 will be obsoleted upon finalization of these proposed regulations.

Comments with respect to the section 385 proposed regulations also raised concerns regarding the application of section 318(a)(4) to options in a joint venture corporation. See Part III.B.2.c.vi of the Summary of Comments and Explanation of Revisions (81 FR 72867). The section 385 final regulations address those comments by providing that section 318(a)(4) applies only to options that are reasonably certain to be exercised as described in §1.1504-4(g). See §1.385-1(c)(4)(iii)(C). Comments are requested as to whether the concerns of the Treasury Department and the IRS concerning the application of section 318(a)(4) for purposes of the definition of related person in section 954(d)(3) would be better addressed by the proposed option anti-abuse rule or a rule similar to §1.385-1(c)(4)(iii)(C).

## 2. Active Rent Exception to FPHCI

Although rents generally are included in FPHCI under section 954(c)(1)(A), rents derived in the active conduct of a trade or business and received from a person that is not a related person are excluded from FPHCI under the active rents exception in section 954(c)(2)(A) and §1.954-2(b)(6). The section 954 regulations provide the exclusive rules for determining whether rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A). Specifically, §1.954-2(c) provides four alternative ways for rents to be derived in the active conduct of a trade or business, one of which applies to rents derived by a CFC from leasing property as a result of performing marketing activities. Under this rule, the CFC derives rents in the active conduct of a trade or business when the CFC satisfies an “active marketing” test, which, among other things, requires the CFC to operate in a foreign country or countries an organization that is regularly engaged in the business of marketing, or marketing and

servicing, the leased property, and that is “substantial” in relation to the amount of rents derived from the property. See §1.954-2(c)(1)(iv). Pursuant to a safe harbor in the regulations, an organization is “substantial” if its active leasing expenses equal or exceed 25 percent of the adjusted leasing profit. See §1.954-2(c)(2)(ii). The regulations generally define active leasing expenses to mean, subject to certain exceptions, deductions that are properly allocable to rental income and that would be allowable under section 162 if the CFC were a domestic corporation. See §1.954-2(c)(2)(iii). The regulations generally define adjusted leasing profit to mean the gross income of the lessor from rents, reduced by certain items. See §1.954-2(c)(2)(iv).

A CFC may derive rent from leasing property that it does not own. In that case, the CFC likely will make payments to the owner of the property, which may be characterized as rent. For purposes of applying the safe harbor, the regulations provide that rents paid or incurred by the CFC with respect to the rental income (i) are not taken into account in determining active leasing expenses (in other words, are excluded from the definition of active leasing expenses); and (ii) are taken into account for purposes of determining adjusted leasing profit (in other words, reduce the CFC’s gross income for purposes of determining adjusted leasing profit). Section 1.954-2(c)(2)(iii)(B) and (iv)(A). These rules reflect the principle that when a lessor CFC derives rents from property that it does not own, the substantiality of the CFC’s marketing organization should be determined under the safe harbor on the basis of the CFC’s income and expenses net of any payments that it makes for the use of the property.

The Treasury Department and the IRS are aware that in cases in which a lessor CFC derives rent from leasing property that it does not own, the CFC may make

payments to the owner of the property that are characterized as royalties rather than rent. For purposes of the safe harbor, there is no reason to distinguish between payments made by the CFC for the use of property based on their characterization as rents or royalties. For example, if a CFC pays \$100 for the transfer of a computer program, and in turn transfers the computer program to an unrelated person for \$150 in a transaction that is treated as a lease under §1.861-18, the determination of whether the CFC satisfies the safe harbor in §1.954-2(c)(2)(ii) should not depend on whether the transaction pursuant to which the CFC received the computer program is characterized under §1.861-18 as a license, under which the CFC pays royalties, or a lease, under which the CFC pays rents. In both cases, the CFC's \$100 payment for use of the computer program should be excluded from active leasing expenses and reduce the CFC's adjusted leasing profit, in order to ensure that only expenses related to the marketing organization are taken into account in assessing its substantiality. Accordingly, the Treasury Department and the IRS propose to revise §1.954-2(c)(2)(iii)(B) and §1.954-2(c)(2)(iv)(A) to apply generally to amounts paid or incurred, including both rents and royalties, by the lessor CFC for the right to use the property (or a component thereof) that generated the rental income.

### 3. Proposed Applicability Dates

These regulations generally are proposed to apply for taxable years of CFCs ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and for the taxable years of United States shareholders in which or with which such taxable years end. However, pursuant to the authority under section 7805(b)(1)(C), the Notice 2007-9 option anti-abuse rule is

proposed to apply for taxable years of CFCs beginning after December 31, 2006, and ending before the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and for the taxable years of United States shareholders in which or with which such years end. Furthermore, pursuant to the authority under section 7805(b)(1)(B), the rules in proposed §1.954-1(f)(2)(iv)(B)(1) and (3) will apply to taxable years of CFCs ending on or after **[INSERT DATE OF FILING FOR PUBLIC INSPECTION]**, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to amounts that are received or accrued by a CFC on or after **[INSERT DATE OF FILING FOR PUBLIC INSPECTION]** to the extent the amounts are received or accrued by the CFC in advance of the period to which such amounts are attributable with a principal purpose of avoiding the application of §1.954-1(f)(2)(iv)(B)(1) or (3) with respect to such amounts. As discussed in Part 1 of this Explanation of Provisions, these rules would prevent taxpayers from effectively electing related person status in inappropriate situations, including to qualify payments for the exception from FPHCI in section 954(c)(6). Accordingly, the Treasury Department and the IRS have determined that an immediate applicability date for these rules is appropriate to address the possibility of acceleration of payments to a period before these rules are adopted as final regulations. Until the effective date of the final regulations, CFCs may rely on the rules in proposed §1.954-1(f)(2)(iv) for taxable years ending on or after **[INSERT DATE OF FILING FOR PUBLIC INSPECTION]**, provided that they consistently apply the rules in §§1.954-1(f)(2)(iv) and 1.958-2(d) and (e) for all such taxable years.

### **Special Analyses**

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

The Treasury Department will submit the final regulations to the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) for Executive Order 12866 review consideration. The Treasury Department requests comment and any potential data regarding the expected impacts of this proposed regulation, including whether the impacts of this proposed regulation will have an annual effect on the economy of \$100 million or more.

Because this rulemaking is an interpretive rule and does not impose a collection of information on small entities, under 5 U.S.C. 603(a) the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. The Treasury Department requests comment on the impacts of this proposed regulation on small entities and businesses.

### **Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as

prescribed in this preamble under the "ADDRESSES" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules, as well as whether modifications to the attribution rules similar to those proposed to be made to §1.954-1(f) should apply for purposes other than the definition of related person under section 954(d)(3) and §1.954-1(f). All comments will be available at [www.regulations.gov](http://www.regulations.gov) or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

### **Drafting Information**

The principal author of these proposed regulations is Rose E. Jenkins of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in the development of these proposed regulations.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.954-1 also issued under 26 U.S.C. 954(b) and (c).

Section 1.954-2 also issued under 26 U.S.C. 954(b) and (c).

\* \* \* \* \*

Par. 2. Section 1.954-0 is amended in paragraph (b) by adding entries for §§1.954-1(f)(3), (f)(3)(i) through (iii), (g), and (g)(1) through (4) and 1.954-2(c)(2)(v) through (viii), (d)(2)(v), (i), and (i)(1) through (3) to read as follows:

§1.954-0 Introduction.

\* \* \* \* \*

(b) \* \* \*

§1.954-1 Foreign base company income.

\* \* \* \* \*

(f) \* \* \*

(3) Applicability dates.

(i) General rule.

(ii) Option rule in paragraph (f)(2)(iv)(B)(2) of this section.

(iii) Anti-abuse rule.

(g) Distributive share of partnership income.

(1) Application of related person and country of organization tests.

(2) Application of related person test for sales and purchase transactions between a partnership and its controlled foreign corporation partner.

(3) Examples.

(4) Effective date.

§1.954-2 Foreign personal holding company income.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(v) Leased in foreign commerce.

(vi) Leases acquired by the CFC lessor.

(vii) Marketing of leases.

(viii) Cost sharing arrangements (CSAs).

\* \* \* \* \*

(d) \* \* \*

(2) \* \* \*

(v) Cost sharing arrangements (CSAs).

\* \* \* \* \*

(i) Applicability dates.

(1) Paragraphs (c)(2)(v) through (vii).

(2) Paragraphs (c)(2)(iii)(B) and (c)(2)(iv)(A) of this section.

(3) Other paragraphs.

Par. 3. Section 1.954-1 is amended by revising paragraph (f)(2)(iv) and adding paragraph (f)(3) to read as follows:

§1.954-1 Foreign base company income.

\* \* \* \* \*

(f) \* \* \*

(2) \* \* \*

(iv) Direct or indirect ownership. For purposes of section 954(d)(3) and this paragraph (f), to determine direct or indirect ownership--

(A) The principles of §1.958-1 and section 958(a) apply without regard to whether a corporation, partnership, trust, or estate is foreign or domestic or whether an individual is a citizen or resident of the United States; and

(B) The principles of §1.958-2 and section 958(b) apply, except that--

(1) Neither section 318(a)(3), nor §1.958-2(d) or the principles thereof, applies to attribute stock or other interests to a corporation, partnership, estate, or trust; and

(2) Neither section 318(a)(4), nor §1.958-2(e) or the principles thereof, applies to treat dividends, interest, rents, or royalties received or accrued from a foreign corporation as received or accrued from a controlled foreign corporation payor if a principal purpose of the use of an option to acquire stock or an equity interest, or an interest similar to such an option, that causes the foreign corporation to be a controlled foreign corporation payor is to qualify dividends, interest, rents, or royalties paid by the foreign corporation for the section 954(c)(6) exception. For purposes of this paragraph (f)(2)(iv)(B)(2), an interest that is similar to an option to acquire stock or an equity interest includes, but is not limited to, a warrant, a convertible debt instrument, an

instrument other than debt that is convertible into stock or an equity interest, a put, a stock or equity interest subject to risk of forfeiture, and a contract to acquire or sell stock or an equity interest.

(3) Neither section 318(a)(4), nor §1.958-2(e) or the principles thereof, applies to treat a person that has an option to acquire stock or an equity interest, or an interest similar to such an option, as owning the stock or equity interest if a principal purpose for the use of the option or similar interest is to treat a person as a related person with respect to a controlled foreign corporation under this paragraph (f). For purposes of this paragraph (f)(2)(iv)(B)(3), an interest that is similar to an option to acquire stock or an equity interest includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock or an equity interest, a put, a stock or equity interest subject to risk of forfeiture, and a contract to acquire or sell stock or an equity interest.

(3) Applicability dates--(i) General rule. Except as otherwise provided in this paragraph (f)(3), paragraph (f)(2)(iv) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and taxable years of United States shareholders in which or with which such taxable years end.

(ii) Option rule in paragraph (f)(2)(iv)(B)(2) of this section. Paragraph (f)(2)(iv)(B)(2) of this section applies to taxable years of controlled foreign corporations beginning after December 31, 2006, and ending before the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and

taxable years of United States shareholders in which or with which such taxable years end.

(iii) Anti-abuse rule. Paragraphs (f)(2)(iv)(B)(1) and (3) of this section apply to taxable years of controlled foreign corporations ending on or after **[INSERT DATE OF FILING FOR PUBLIC INSPECTION]**, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to amounts that are received or accrued by a controlled foreign corporation on or after **[INSERT DATE OF FILING FOR PUBLIC INSPECTION]** to the extent the amounts are received or accrued in advance of the period to which such amounts are attributable with a principal purpose of avoiding the application of paragraph (f)(2)(iv)(B)(1) or (3) of this section with respect to such amounts.

\* \* \* \* \*

Par. 4. Section 1.954-2 is amended by:

1. Revising paragraphs (c)(2)(iii)(B) and (c)(2)(iv)(A).
2. Revising the heading of paragraph (i).
3. Redesignating paragraph (i)(2) as paragraph (i)(3).
2. Adding new paragraph (i)(2).

The revisions and addition read as follows:

§1.954-2 Foreign personal holding company income.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iii) \* \* \*

(B) Deductions for amounts (including rents and royalties) paid or incurred by the lessor for the right to use the property (or a component thereof) that generated the rental income;

\* \* \* \* \*

(iv) \* \* \*

(A) Amounts (including rents and royalties) paid or incurred by the lessor for the right to use the property (or a component thereof) that generated the rental income;

\* \* \* \* \*

(i) Applicability dates. \* \* \*

(2) Paragraphs (c)(2)(iii)(B) and (c)(2)(iv)(A) of this section. Paragraphs (c)(2)(iii)(B) and (c)(2)(iv)(A) of this section apply for taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and for the taxable years of United States shareholders in which or with which such taxable years end.

\* \* \* \* \*

Par. 5. Section 1.958-2 is amended by revising paragraph (d)(1) introductory text and the first sentence of paragraph (e) and adding paragraph (h) to read as follows:

§1.958-2 Constructive ownership of stock.

\* \* \* \* \*

(d) \* \* \*

(1) \* \* \* Except as otherwise provided in paragraph (d)(2) of this section and §1.954-1(f)--

\* \* \* \* \*

(e) \* \* \* Except as otherwise provided in §1.954-1(f), if any person has an option to acquire stock, such stock shall be considered as owned by such person. \* \* \*

\* \* \* \* \*

(h) Applicability date. Paragraphs (d)(1) and (e) of this section apply for taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and for the taxable years of United States shareholders in which or with which such taxable years end.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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